IETA
INTERNATIONAL EMISSIONS TRADING ASSOCIATION

Comments of IETA US Working Group on Draft Recommendations of the Market Advisory Committee to the Air Resources Board

Key Points

Emissions trading delivers effective environmental policy outcomes at a far lower cost than command and control or tax-based approaches, simply by allowing a market to set the appropriate price. It is not a complete policy solution, but it is a powerful policy tool to achieve environmental objectives.

Emissions trading does not create new resources. Emissions trading uses the efficiency of markets to minimize the social costs of a carbon constraint necessary to confront climate change.

Simplicity and transparency are virtues in the design of environmental markets, allowing market participants to make investments in a predictable framework while providing the public a means to ensure environmental integrity.

Markets are more efficient when they are larger and more diverse. IETA strongly endorses the recommendation of the Market Advisory Committee to seek linkages that will bring California into the global carbon market

Offsets provide a powerful tool to drive innovation in sectors that are not suited to cap-and-trade mechanisms, allowing the powerful effects of carbon pricing to extend through more of the economy. International project-based reductions will also provide opportunities for Californian clean technology exporters to capture first mover advantages in a global market

A GHG market should provide incentives for early action in sectors inside and outside the cap and trade system. Where early action has already taken place, it should similarly be rewarded

The most powerful mechanism for cost containment is a broad, deep, and liquid GHG market. Price caps and safety valves will ultimately work against the ability of a market to deliver environmental objectives at lowest cost

20 Eglinton Ave. W. Suite 1305
P.O.Box 2017
Toronto, Canada M4R 1K8
Tel: (416) 487-8591
Fax:(416) 481-2625

4, Chemin des Conches CH-1231
Conches-Geneva Switzerland
Tel: (41 22) 839-3154
Fax: (41 22) 839-3181

IETA is a non-profit business organization that "is dedicated to ensuring that the objectives of the UNFCCC and ultimately climate protection are met through the establishment of effective global systems for trading in greenhouse gas emissions (GHG) by businesses, in an economically efficient manner while maintaining societal equity and environmental integrity".

IETA's membership is currently 154 companies of which 50% represent industrial organizations that see emissions trading as essential to meet existing or future regulatory constraints. The balance represent project developers, intermediaries, financial institutions, brokers, verifiers, legal firms, etc engaged in a new economic activity as a result of the GHG market. IETA's industrial membership collectively emits an amount equivalent to the combined GHG emissions of Germany and the United Kingdom.

The role of IETA is to provide input on design issues related to greenhouse gas emissions trading by advocating flexibility, openness, and encouraging optimum liquidity. IETA does not participate in the scientific debate over climate change or advocate legislation for mandatory caps and timetables. IETA's goal is to facilitate the establishment of efficient liquid emissions trading markets that will help participants to achieve compliance with regulatory regimes in the most cost effective manner.

In executing this mission, IETA has emerged as the pre-eminent voice of the business community in the UNFCCC process, serving as an active partner in the evolution of the Clean Development Mechanism and Joint Implementation. IETA has played an important role in the development of the European Union's Emissions Trading Scheme. IETA has served as the meeting place for the business community to develop essential standards to facilitate market functioning across both of these critical pillars of the international carbon market.

Program Scope

IETA supports a cap and trade system that covers as high a percentage of emissions from the economy as is practicable. Broad coverage of sectors with different marginal costs of control allows for the market to achieve cost savings. The different marginal costs of regulated firms covered by the system allows firms to sell emissions rights to others whose internal control costs are higher creating a win-win for both. This creates a revenue stream for sellers providing incentives for investment in additional reduction measure while creating incentives for cost control for firms whose internal control costs are higher. This will occur to a greater extent by covering as high a percentage in the program as possible.

A key question in the design of an emissions trading system is the treatment of transport sector emissions. Emissions from this sector are rising rapidly, and are a very large percentage of California's emissions. An effective emissions trading program ideally

places the constraint at the point of the activity that creates the actual emissions. This provides a price signal to affect behavior. This is clearly challenging with respect to the personal transport sector given the multitude of sources and that consumer transport emissions have been shown to be relatively unresponsive to a price signal. This would suggest that inclusion of the road transport sector in a cap-and-trade system could be less effective than for other sectors.

These challenges must be weighed against the consideration to include the highest percent of emissions in a treading system in order to achieve the benefits stated previously. The sector comprises too large of a percentage of the economy's overall emissions to be excluded indefinitely. Equity across all sectors of the economy is an important consideration for the committee to consider as it develops and debates legislation. In addition, alternative policy measures may well be significantly less efficient than a cap and trade system in achieving environmental and economic costs. We believe that options are available that would allow a program to capture emissions from transport fuels.

A core principle in the design of an emissions trading system is to impose the constraint at the point of activity that creates the emissions. This provides the greatest incentive for the emitter to take actions that reduce emissions and control cost.

IETA believes that that the constraint should be imposed downstream for covered stationary sources. The constraint and provision of allowances to such sources has the greatest potential to achieve the objective of cost control. These sources would be powerfully incented to reduce their emissions at the lowest possible cost. Legislation and regulation that controlled conventional air pollutants such as sulphur dioxide (SO_2) and oxides of nitrogen are examples of this approach that can be emulated, as well as the operations of the European Union's emissions trading scheme (EU ETS)

It is clear that some sectors are most effectively included with an upstream regulatory structure. In order to broaden the scope of the market, it is necessary to consider some measure of compromise in the design approach. As such, IETA would recommend a hybrid approach using a downstream design as the initial point of departure, as proposed by the Market Advisory Committee, provided that expansion of the system is informed by cautionary principles.

IETA endorses the principle of covering only large emitters in the initial phase of the emissions trading system, and then phasing in additional sectors and facilities to expand the program later. Experience shows that large emitters with well understood abatement costs should be included earlier, whereas early inclusion of small emitters is not cost-effective and may overburden management, regulatory and verification resources.

IETA would recommend that California commit to a regulatory timetable and pre-specified process that must be adhered to both before altering the thresholds for coverage within the initial sectors, and before expanding the scope of the system beyond those

sectors. Providing this timetable and process prior to commencement of the scheme will improve transparency and reduce market uncertainty once the program is operating.

A key principle of determining sectoral inclusion is that the trading sectors should not be unduly advantaged by their inclusion in the cap-and-trade program. At a sectoral level, the abatement burden should be fairly allocated across the trading and non-trading sectors. Ideally, firms should not have an incentive to resist inclusion in the program, but actually prefer it as a providing greater flexibility in meeting an identical burden.

Issues Specific to the Electricity Sector

IETA recognizes that the problem of leakage is of particular concern for the electrical sector in California. However, we are concerned that this policy concern might dominate the design of the market program for a critical sector in California, and in particular weaken the capacity of the California program to define a precedent for a Federal program. Both the load serving entity model and the first seller model introduce additional complexity to a simple emissions source approach.

In implementing a first-seller approach, it would appear inevitable that the reporting obligation would rest with the first seller, while allocation and the obligation to reduce must be placed elsewhere, presumably with a load-serving entity. This separation between reporting and regulation will significantly limit the potential transparency of the system. Further, it may have unforeseen consequences in the interaction of the electrical sector with the broader Californian GHG market.

IETA believes that the use of a first-seller approach is preferable to a load-serving entity model, particularly because it would be more compatible with a generator-based Federal program that would not need to incorporate leakage concerns to the same extent. However, the institutions necessary to implement such a structure are not simple, nor proven. As California pursues this course, it should be careful to ensure that its electrical sector is not disadvantaged in a future Federal program.

IETA endorses the recommendation of the Market Advisory Committee that in the long term, consumers must incorporate the full price impact of a carbon constraint into their electricity usage decisions in order for the objectives of AB32 to be met at optimal social cost.

Other Design Issues

1. Allocation

An emissions trading program does not create new wealth. The imposition of a carbon constraint on an economy must have costs. Emissions trading is merely a mechanism to minimize those costs through market efficiency and gains from trade. The created

property rights clearly have value, but should properly be viewed as simultaneously adding fungibility and scarcity, which is not identical to wealth creation. Firms with a compliance obligation will be no better off in net assets, and any benefit received will be a function of their ability to flow through costs.

To the extent that a carbon premium will exist, this is not a failure of policy. Price signals promote efficiency in consumption, production, and investment. A pass-through of costs will in the long-term be subject to competitive pressure downward.

Any allocation of permits involves distributional consequences. Auctioning permits could be seen as transferring wealth equivalent to the new cost of carbon from liable parties and energy users to taxpayers. Free allocation of permits assigns rents to the recipients—at the expense of taxpayers and/or energy users, depending on the structure used, but not necessarily at any new incremental expense.

The use of early large scale auctions as some parties are proposing is a risky undertaking that ignores the realities of market formation. Any such use of auctioning as an allocation method for emissions trading should be carefully considered on the basis of both equity and efficiency. Auctioning has significant appeal as an allocation method for an emissions trading system, and may address some of the outcomes that have been observed in emissions trading programs in other jurisdictions. However, there is reason to believe that the use of 100% auctioning to initiate an emissions trading system is not optimal on either count, and will result in far greater economic impact on emitters than is necessary to achieve the environmental objectives.

Many of the arguments deployed in support of extensive use of auctioning rest on a conflation of two issues: observed effects of marginal cost pricing in electrical markets and the purposes of an allocation process for emissions trading. A gradual transition to more extensive use of auctioning would be more prudent public policy, realizing efficiency gains from a more effective market while striking a compromise on the inevitable issues of equity. The allocation process should not be called upon to achieve the policy objectives of the program, merely to initiate the process and allow the power of the market to drive abatement.

An inherent risk of large initial auctioning is that the auction may emerge as an alternative to a competitive carbon market. Further, the use of initial large auctions runs the real risk of significantly increasing compliance costs with no additional environmental benefit. Both of these considerations suggest the wisdom of the cautionary principle.

In this regard, IETA supports the recommendation of the Market Advisory Committee that any move toward auctioning be gradual, and sectors which have no significant capacity to recover the cost of the allowance value be considered separately to avoid exacerbating the competitive effects of the GHG market program. Where considering the use of auctioning due to the possibility of pass-through costs, this adjudication should

be conducted with a cautious eye toward the significant economic damage that may result from the imposition of costs that are not in fact recoverable.

Any revenues generated by any auction of allowances should be used strictly as a form of trust fund for the greenhouse gas reduction objectives of the program, and not as a revenue source. The purpose of an emissions trading system is not to serve as a carbon tax generating revenue, but to place a marginal cost on the use of the carrying capacity of the environment. IETA opposes in principle the diversion of revenues derived from the allocation of allowances with a GHG trading system to policy objectives other than the reduction of GHG emissions.

2. Recognition for Early Action

IETA supports the stated intention of the Market Advisory Committee report to reward and not penalize sources for early action toward abating greenhouse gas emissions. The creation of a price for carbon is intended to stimulate voluntary abatements by providing an incentive for the reductions, and flexibility in time is an important potential source for liquidity. A mechanism to recognize early action in anticipation of the regulatory framework under development will allow reductions to proceed in a time frame dictated by the investment cycle, not the pace of regulation. This must necessarily reduce overall costs necessary to achieve the objectives of AB32.

Auctioning cannot meaningfully be said to reward early action, particularly in sectors unable to flow through costs. There is no incentive to reduce prior to the compliance period, simply an incentive to reduce anticipated costs. As noted, benchmarking provides an incentive for early action. However, grandfathering against a pre-compliance year baseline also provides an incentive for early action, as potential revenue. Ultimately, it is questionable whether any method of allocation can effectively drive early action, and IETA would simply recommend the two issues be considered separately.

We find it unfortunate that the definition of early action implied does not any recognize efforts undertaken by California emitters prior to the passage of AB32. This is doubly unfortunate in light of the fact that many of these sources have initiated their abatement efforts within the internationally recognized framework of the California Climate Action Registry.

Contrary to the conclusion of the report, IETA does not recommend the development of direct financial incentives and regulation to stimulate early action. This is an unnecessary intrusion of the State into a GHG market and an unnecessary subsidy for business. For sectors covered under the cap, the issue of additionality is not directly relevant where firms may freely time their pre-compliance investments. The administration of direct financial incentives is likely to involve questions and difficulties very similar to any additionality test.

IETA would recommend that the Air Resources Board grant fully fungible compliance credits for early action, without considering them as identical to offsets. By definition, questions around early action are temporary while the issue of additionality for offsets is not. Alternatively, the Air Resources Board may commit to a principle of recognizing early action within the process of setting sectoral targets.

With regards to an offset system, IETA would urge the State to move as quickly as possible to establish a State offset system to allow such investments to proceed. Allowing the development of compliance credit from the investment in offset projects from 2008 toward the 2012 compliance year will permit a significant range of opportunities to proceed immediately. Further, it will stimulate reductions in sectors not expected immediately to be included under the cap.

3. Offsets

IETA supports many of the recommendations of the Report regarding offsets, and broadly endorses the criteria set out to define project-based reductions. As noted above, IETA recommends that the Air Resources Board move as soon as possible to develop an offset system for California to permit immediate investment in early abatements in sectors that will not be initially covered under the cap.

There are considerable advantages to a standards-based approach, critically including regulatory predictability and low transactions costs, while ensuring environmental approach. However, IETA would recommend that the Air Resources Board draw positive as well as negative lessons from the evolution of the Clean Development Mechanism.

No regulator can possibly predict the wide range of possible abatements, develop, and successfully deploy offset standards at the pace necessary to keep pace with the innovation and creativity stimulated by a robust GHG market. The growth in quantities and project types within the CDM in the past four years has exceeded all expectations. An essential element of this has been the capacity to allow entrepreneurs to discover new opportunities and put forward methodologies for addressing them. A pure standards-based system will act as brake on this process.

IETA would therefore recommend that California implements a hybrid approach, utilizing standards wherever possible, but allowing for the possibility of a case review as a mechanism for defining protocols.

We strongly support the recommendation to allow offsets without any restriction on geographic scope or quantity. The extent of environmental co-benefits achievable is questionable, while the costs that California has chosen to bear in confronting climate change are not. California will benefit greatly as an exporting center of clean technology by allowing its businesses to compete without restriction for abatement projects, while at the same time minimizing costs. The Clean Development Mechanism has been a

powerful force for leverage of clean technology investment, and a Californian program will provide California business with similar opportunities.

In this regard, IETA further endorses the recommendation to allow credits from the Clean Development Mechanism and Joint Implementation to qualify for compliance in California. Participation in CDM/JI projects will open new avenues for Californian technology exports. Equally important, this openness will place California at the forefront of jurisdictions leading the international effort against climate change using the global carbon market.

4. Cost-containment

Cost control is a key principle of climate legislation, and a safety valve may be one mechanism available to control costs that may have considerable appeal to California business. However, any such price cap will have adverse impacts on the effectiveness of a GHG market program, and in the long-term lead to higher costs. Ultimately, a price cap will compromise the environmental integrity of the program. The most robust possible cost control mechanism is an effective market with the broadest possible supply of abatements.

Market design should avoid mechanisms which seek to directly manage, cap or maintain the associated price for emissions and/or to manage the associated supply and demand of allowances with a view to indirectly managing, capping or maintaining the price for allowances.

IETA supports the provision for banking as a mechanism for rewarding overcompliance and allowing long-term flexibility. Similarly, a three-year compliance period will make the program more resistant to external shocks. The possible drawback to a three-year compliance period is a market heavily concentrated around the compliance deadline, and therefore inefficient and lacking liquidity for much of the compliance period. However, IETA believes that the recommendation to include a broad role for offsets and link to other markets will assure market viability.

5. Linkage

IETA strongly supports the conclusions of the Market Advisory Committee Report, particularly the recommendation to actively promote a global carbon market through linkage with other mandatory GHG trading systems. This openness to developing formal linkage with other programs, combined with the recommendation to accept international project-based reduction credits from CDM/JI, is a position of enormous importance as the United Nations head toward the critical discussions of the global carbon market post-2012.

Emissions trading delivers economic efficiency by discovering and exploiting differential costs of abatement. Linking to create a larger carbon market improves the efficiency of

emissions trading for two fundamental reasons. Firstly, a larger market is inherently more efficient, liquid, and competitive. Secondly, a larger market provides a broader pool and greater variety of abatement costs in which to discover opportunities for low-cost abatement.

Globally, linking allows more GHG abatement to occur with the same level of social resources, or conversely the increased efficiency can reduce the social costs of a given carbon constraint. As we contemplate the need for more aggressive targets for greenhouse gas reduction in the face of the growing body of scientific evidence, it becomes essential to make lowest cost abatement the overriding concern.

Linking requires a careful assessment of the two systems for structural compatibility along three dimensions: technical, environmental, and competitive/economic. In considering linking, it is important to remember that the more extensive the link, the greater degree of inherent reciprocal acceptance of design elements. Some elements therefore preclude or significantly complicate linking. IETA recommends that the Air Resources Board bear this consideration in mind in designing California's GHG market.

In particular, IETA supports the recommendation for transparency and public access to emissions data in developing the program. Some consideration must be given to the fact that this data is market-sensitive, which will require certain periods of confidentiality and a coordinated release process.

Administrative Issues

1. Emissions monitoring

In order to provide public confidence in environmental integrity and facilitate linkage with other GJG systems, IETA universally recommends the use of independent third-party verification as the basis of a robust GHG market program.

2. Reporting

IETA endorses the recommendation to use the facility as the reporting entity. Regulatory consistency with pre-existing programs will allow firms to minimize costs more effectively.

While IETA supports the principle of transparency and public access to data, competitive concerns regarding confidentiality should receive some consideration, particularly with respect to timing. The release of market-sensitive data should be orderly and predictable.

3. Compliance and enforcement

IETA urges that any market program includes a 'make good' provision as part of the penalty structure.

4. Implementation

While there are compelling public policy reasons for making emissions data public, and an integrated data system will offer significant advantages, IETA would urge the Air Resources Board to consider carefully the necessity of and possible drawbacks arising from any unnecessary involvement in the GHG market.

In particular, the recommendation that the Air Resources Board act as transfer agent for sources conducting transactions is a function outside its established regulatory capacity that potentially expose it to liabilities and compromise its ability to act as a pure enforcement body. It is critical to the success of any GHG market that the public have confidence in an independent regulatory authority at arm's length from the market beyond the achievement of the environmental objectives of the program.

5. Program Evaluation and Adjustment

IETA agrees with the need to maintain clear and open communication in order to build trust in a cap and trade program. However, as a cautionary note, the Air Resources Board should be careful to balance 'learn by doing' with the need for regulatory certainty. Carbon pricing is most effective at driving change where firms are able to incorporate the structure of the program into long-term investment decisions.

Conclusion

While IETA does not agree with the entirety of the draft Recommendations of the Market Advisory Committee, taken as a whole the Report is a compelling and effective contribution to the design process for a carbon market program in California. In particular, the recommendations to develop linkage to other mandatory greenhouse gas market programs and to accept international credits from the Clean Development Mechanism constitute a critical milestone in the development of a global carbon market to address the challenge of climate change. In this regard, the Report continues to demonstrate California's leadership on environmental issues on a global stage.